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Recent Performance of Rural Financial Markets in Low Income Countries

by

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1. Introduction

During the past three decades financial services have expanded substantially in rural areas of many low income countries (LICs). This has included the funding of a large number of rural credit projects, very major increases in volume of formal loans, building many new financial institutions, and some mobilization of financial savings. The overt objectives of these activities have been to increase agricultural output, to ease rural poverty, or to offset the effects of disasters or public policies which damage rural interests. Despite the very substantial changes realized, a few observers, myself included, are not satisfied with the overall performance of rural financial markets (RFMs); I am convinced that formal RFM activities in a majority of the LICs are frought with problems and that they are contributing little to development.[1/] In the following discussion I attempt to outline and clarify the main issues which must be addressed if the performance of RFMs is to be understood and also improved. This includes a brief review of historical views on financial markets, a critique of the assumptions which underlie many programs in this area, and a summary of common problems and policies found in LICs. The paper concludes with suggestions for policy changes.

2. Evolution of Views on Financial Markets

Views on the role of finance in economic development have changed substantially. For centuries financial market activities were viewed with hostility, and usury was widely condemned. Both the Bible and the Koran forbid the taking of interest (Nelson). These negative attitudes toward financial markets were carried to the Americas as well as Africa. Similar anti-lender, class-struggle views are also prominent in many socialists' works.

During the past 100 years much of the animosity toward banks and lenders in general, at least in most Christian countries, has disappeared.[2/] Initially, this was replaced by a feeling that financial markets played largely a neutral or passive role in development. It became widely accepted that growth in financial markets was a necessary part of economic development. Some have argued that these financial services emerge automatically as the demand for financial intermediation is created by growth in real economic activities (Patrick). Individuals of this persuasion go on to argue that loans are merely "lubricants" for real production processes. The introduction of a high yielding wheat variety, for example, may stimulate farmer demand for purchased inputs. Firm-households lacking sufficient liquidity to buy optimum amounts of these inputs seek loans to satisfy their additional needs for liquidity.

In the past 20 years it has become common in many countries to attempt to use financial markets to force the pace of economic development - a "supply led" strategy. Policy makers have concluded that rapid expansion in the supply of financial services combined with concessionary interest rates and non-market loan rationing, can be used to accelerate economic development. A few observers recently have focused criticism on the distortions in financial markets caused by this strategy. These criticisms concentrate on interest rate policies (McKinnon, Shaw). Critics hold that low and fixed interest rates on financial instruments retard savings and capital formation, fragment financial markets, cause inefficient allocation of resources, and also cause further distortions in income distribution and asset ownership. They go on to argue that policy makers should adopt flexible interest rates which adjust with general price changes, and that this would cause financial markets to play a positive role in the development process.

Concerns about the effects of a supply led strategy are particularly relevant in LICs. Most of the LICs which are market oriented heavily distort their rural financial markets. In most cases, RFMs are force-fed large amounts of funds by Central Banks, and interest rates are set below other rates allowed on non-agricultural loans. It is also common for the policy makers to fix interest rates still lower on loans for the rural poor. Usually, RFMs are more heavily administered, regulated, and distorted than any other set of markets in a country. Unfortunately, many of the policies which strongly affect the performance of RFMs are built on assumptions which have not been verified.

3. Common Assumptions

A causal observer often is impressed with the uniqueness of RFMs in each country. In part, this is due to the diversity found among financial institutions servicing rural needs. More careful analysis, however, reveals a large number of similar assumptions supporting most rural credit-savings programs. To understand the current maladies in RFMs, it is necessary to expose and evaluate these assumptions.[3/]

At the farm-household level it is often assumed that the rural poor face credit shortages, that they pay exorbitant amounts for the use of informal loans, and that they need careful supervision in order to use loans wisely. It is further assumed that most farmers need additional loans in order to adopt profitable new technology, and that concessionary interest rates are needed on formal loans to induce farmers to borrow. It is also assumed that interest charges make up the bulk of the borrowing costs for most farmers, and that the loan demand among most farmers, especially small farmers, is very interest rate elastic. Typically, rural households are also stereotyped as having little or no voluntary savings capacities.

Several strongly held assumptions relate to lender behavior. These include the feeling that informal lenders provide the majority of the loanable funds in most low income countries, and that formal lenders are tradition bound and do not make loans in a socially desirable manner. It is also assumed that formal lenders can effectively ration funds by granting loans only for production or by making loans in-kind. Policy makers also feel that formal credit should not be extended for consumption purposes.

Important assumptions about informal lenders are also evident. These include the ubiquitous feeling that money lenders regularly extract large monopoly profits, charge exorbitant interest rates, regularly take advantage of the economically weak, do not provide legitimate economic services, and that they ought to be closely regulated or eliminated.[4/]

There are also a number of widely held assumptions about the overall performance of RFMs in low income countries. One of the most common is that RFMs can be closely regulated and their performance controlled by administrative fiat. Heads of government often feel a need to develop an "aura of action" soon after they assume office or immediately after a national emergency. It is common for governments to announce new agricultural loan programs which include loan supply increases as well as concessionary terms. In a few cases it may also include refinancing or forgiveness of formal debts. A number of governments also try to offset product pricing policies, or exchange rate policies, which are adverse to farmers, by introducing concessionary interest rates in RFMs. Foreign aid agencies eagerly jump into this process because it is generally easy for them to prepare and implement agricultural credit projects.

4. Common Problems

Because many countries base their RFM policies on very similar assumptions, it should not be surprising that these policies across LICs are much alike. This includes low and inflexible contractual interest rates on agricultural credit and deposits, major infusions of loanable funds into RFMs via Central Banks, and formation of new specialized institutions to provide financial services to specific segments of the rural population. It is also common for governments to attempt to alter the performance of RFMs by some combination of policy techniques.

Two sets of problems tend to be associated with these activities. The first set includes relatively tractable, and widely recognized problems which are often associated with any new business: management and training difficulties. There is almost always a shortage of adequately trained people to fill positions in financial institutions. Slowness in making loan decisions, high cost lending operations, data processing problems, poorly designed loan repayment procedures, and lack of coordination between credit programs and other development efforts are examples. As financial markets develop most of these problems are eased.

The second set of problems is much less widely recognized, although probably more important. These problems might be labeled "unsatisfactory performance of RFMs." At least ten features of this unsatisfactory performance are present in a large number of LICs. In many countries these problems have intensified during the past few years. They include the following:

1) With significant amounts of inflation, it is often difficult for some governments to increase or even maintain the purchasing power of the formal agricultural credit portfolio (e.g.

The Philippines, David). Capital erosion caused by fixed interest rates and substantial inflation is often a major contributing factor.

2) Serious loan repayment problems further reduce the vitality of some loan portfolios (e.g. Jamaica, Graham and others). In many cases these loan repayment problems emerge in all loan size groups.

3) It is often the case that financial markets resist lending to the agricultural sector (e.g. Bolivia, Ladman). In some cases changes in the economic environment may cause financial markets to retract from agricultural lending.

4) Closely associated with this, it is very difficult to induce RFMs to service the rural poor (e.g. The Dominican Republic, Ladman and Adams). Under some conditions RFMs may resist lending to small farmers even more strongly than they resist lending to agriculture in general.

5) In almost all cases, RFMs in LICs do not provide a significant amount of medium and long-term loans (e.g. Bangladesh, Adams and Nelson). The average term structure of the formal loan portfolio is typically quite short, and much of the agricultural credit is granted for only a single cropping season.

6) In most LICs the RFMs are quite ineffective in mobilizing voluntary rural savings (e.g. Brazil, Araujo and Meyer). With only a few exceptions, formal RFMs largely depend on central banks to supply a large part of their loanable funds. Many agricultural banks in LICs do not provide savings deposit facilities.

In the few cases where rural institutions do mobilize financial savings, they are often siphoned out of rural areas for use in urban centers (e.g. Thailand, Meyer and others).

7) It is also common for formal lenders to burden at least part of their actual or potential borrowers with relatively large loan transaction costs (e.g. Bangladesh, Brazil and Colombia, Adams and Nehman). Part of these costs are transferred from the lender to the borrower indirectly by lender procedures.

8) Typically, RFMs are badly fragmented (Gonzalez-Vega, 1976). Each lender tends to service a narrow slice of the rural population. There is also relatively little competition between formal and informal lenders (e.g. Vietnam, Barton). As a result, a wide range of interest rates and borrowing costs can be found across RFMs and intermediation by RFMs does not result in efficient allocation of resources. Some individuals are forced to consume their "surpluses" or invest them in very low return activities, while others must skip profitable investment opportunities because they lack additional liquidity.

9) In many LICs, activities in RFMs adversely affect income distribution and asset ownership (e.g. Costa Rica, Vogel). In large part, this is due to the concentration of most formal loans in the hands of relatively few borrowers. These fortunate borrowers may realize an income transfer due to negative real rates of interest on the credit. They may add to this by turning a profit through the productive use of credit. In addition, borrowers may be able to bid away productive resources

from less fortunate non-borrowers. As a result, non-borrowers are forced to pay higher prices for resources, or to do without. Small savers are almost always denied decent rates of return on their financial savings deposits.

10) Many current RFM policies make it very difficult to introduce successful innovations into rural financial markets (e.g. Adams and Ladman). Typically, a promising RFM innovation is tried on a pilot project basis, but ultimately fails because it cannot reduce cost enough to overcome the effects on lender revenues of suppressed interest rates. As a result, many innovations in rural financial markets are aimed at circumventing regulations. These kinds of innovations typically increase rather than decrease costs.

Common Technique Used

Governments use several general strategies in attempts to alter the performance of RFMs. One strategy includes creating new specialized financial institutions to service the needs of a specific target group in rural areas. Another strategy concentrates on inducing a major part of the financial system to provide more financial services in rural areas. This latter strategy may include large increases in the supply of formal loans, nationalization of all or part of the financial system, use of loan size limits, and adoption of lending quotas. It may also include policies like loan guarantees or crop insurance, differential rediscounting spreads, government purchases of equity in financial institutions, and differential interest rates for various ultimate borrowers. A brief critique of these strategies and techniques follows.

<u>New Institutions</u>

Governments often attempt to achieve certain goals by focusing on one segment of the rural population. In many cases a target group in rural areas, such as small farmers or livestock producers, for example, are thought to have unique problems which require a new financial institution to service their needs. A supervised credit program, new agricultural banks, cooperatives, or commodity banks are often established to service these needs.

In some cases, especially in Africa, new financial facilities clearly are needed to extend financial coverage. There are a number of cases, however, where more bricks and mortar in financial facilities are not needed. Ample financial facilities exist in many Latin American and Asian countries; the main problem is that the overall performance of RFMs is unsatisfactory. Frustration over this poor performance often results in new financial facilities being built. Many governments feel that the new facility will be more flexible, enlightened, and more cooperative in helping governments to achieve public goals. Typically, however, the new institution is staffed with individuals hired from existing financial institutions. Also, the new institution usually is required to live within rules laid down for other lenders. Governments or foreign agencies typically provide special short-term subsidies to start the institution. The new lender initiates its activities with a flourish fortified by a number of radio announcements and newspaper headlines about how, for the first time, a certain group in rural areas is finally receiving formal loans. A small farmer credit agency, for example, will quickly fill it's loan portfolio with loans extended to operators of small farms. In some cases, many of these "new" borrowers are former borrowers of other financial institutions who have been encouraged to seek credit from the new agency. Everyone is happy with the new arrangement: old lenders get rid of that part of their loan portfolio which was least profitable, the new agency extends money to the desired target group, borrowers often receive less hassle and larger loans from the new agency, governments feel good about reaching the target grooup, and foreign agencies feel that terms of their loans or technical assistance agreements have been met.

Over the next several years thing proceed relatively smoothly. Some of the farmers who received credit the first year or two have problems repaying loans, but are refinanced. As the agency starts to question the refinancing of short-term loans, a number of medium-term loans come due, and it slows the expansion in volume of loans, loan repayment problems become much more visible. At about the same time, foreign agencies or local governments begin to insist that the lender do without external subsidies. The lender often is given a double blow: default problems escalate at about the same time that subsidies are withdrawn. The very existence of the lender is threatened unless these two problems can be resolved. Typically, lenders do this by rotating their loan portfolios toward those borrowers with better repayment records, those cheaper to supervise, those with ample loan collateral, and those whose loans result in relatively low marginal costs to lenders. The lender goes through a metamorphose. Like a chameleon the lender takes on the same spots and shades as other financial institutions and performs in much the same manner as it's financial cousins. Country after country has gone through the frustrating experience of seeing credit agencies set up to service rural poor, but later rotate their activities away from the original target group.

Supply Increases

The basic notion behind using the supply increase technique is that if sufficient loanable funds are poured into RFMs, eventually some of these funds will filter down to the desired target groups. Results from the recent Brazilian experience, however, strongly suggest that large supply increases, when combined with concessionary interest rates, may not reach a large majority of the rural residents. Adams and Tommy report that very little of the three-fold real increase in formal credit in Brazil over the 1965-1969 period filtered down to small or new borrowers in one area of Southern Brazil. Out of a total of 338 representative farmers surveyed, they report that 11 of the largest farmers received over two-thirds of the increase in volume of formal loans made to all 338 farmers over the 1965-1969 period. Because of the negative real rates of interest in Brazil, borrowers who have access to the "sweet money" want very large amounts. Lenders, at the same time, have strong incentives to concentrate loans in the hands of borrowers who have substantial wealth, experience with the lender, secure collateral, and who will take large loans (Gonzalez-Vega, 1976). The net result is that very little of the increased supply of cheap loans filters down to small and new borrowers, despite major increases in credit supply.

Nationalization

Several countries including India, Bangladesh, Costa Rica, Sri Lanka and Afghanistan have nationalized part of all of their formal rural financial markets in an attempt to more directly influence their performance. Fragmentary evidence, especially from Bangladesh, Costa Rica and India, suggests that nationalization may have a weaker effect on lender behavior than many policy makers had hoped (Rahim, Gonzalez-Vega, 1973, Shetty). It is relatively easy to draw up regulations for a financial system, but difficult to enforce these regulations where decision makers affected by these regulations are widely disbursed. In market economies it appears to make little difference whether lenders are private, mixed, or publicly owned; managers are judged by the amount of economic surplus they generate.

Loan Size Limits

A few countries have used loan size limits in an attempt to force lenders to alter the make-up of their loan portfolios. These limits often specify a maximum size loan. The policy maker assumes that these limits will force lenders to direct part of their lending to new, more socially desirable activities. Unfortunately, loan size limits are often ineffective in forcing lenders to alter loan portfolios. If lenders reduce the number of large loans in their portfolio, while adding more small loans, they will often experience a substantial increase in lending costs. To avoid this, lenders may meet the letter of the loan size regulation, but evade the spirit, by making multiple small loans to former borrowers of large amounts.

Lending Quotas

Most LICs use some form of lending quota as a way of allocating loanable funds among sectors of the economy, among lenders, and among ultimate borrowers. At a sectoral level, governments may impose certain minimum percentages or amounts which institutions must lend to certain sectors. For example, currently in Thailand all commercial banks are required to lend a minimum of 11 percent of their loan portfolio for agricultural purposes. In Colombia, banks must lend a minimum of 15 percent of all their loans to agriculture. At the lender level, regulations may state that a certain part of the loan portfolio must go to a specific target group. In the Philippines, for example, banks at one time were required to lend a minimum of 10 percent of their new loans to agrarian reform participants. At the borrower level it is common for lenders to allocate credit on the basis of so many units of money for each unit of land in a given crop.

There are at least three major drawbacks to these loan quotas. The first is that lenders may simply redefine loans to meet new loan quota regulations or lenders may ignore the credit plan altogether (Vogel and Larson). Lenders may be able to redefine a sufficient number of their loans and meet quota requirements without changing the real pattern of their lending. The second disadvantage emerges when quotas are in fact effective in changing real portfolio make-up. Some specialized lenders may find it difficult to effectively place and administer loans outside their areas of specialization. A third disadvantage results from fixed loan quotas for individual farmers. Some farmers may have profitable investment opportunities which are much larger than their loan quota. Other borrowers may find their loan quotas far exceed their additional liquidity needs.

Loan Guarantees

A number of countries including Mexico, Peru, the Philippines and Sri Lanka, have used loan guarantees or crop insurance to alter lender and borrower behavior. Loan guarantees transfer part of the risks and uncertainties of lending from one agency to another agency. The most serious disadvantage of these guarantees is the administrative difficulties of assessing, in a timely manner, the legitimacy of claims. Agricultural disasters may affect large numbers of producers in very short periods of time. It is very difficult, for example, to correctly access massive and widespread crop damage from hurricanes or typhoons within several weeks after they happen. Loan guarantee programs, as a result, are costly and cumbersome to administer.

Rediscount Spreads

One of the most widely used techniques in LICs for altering lender behavior is preferential rediscount spreads. A major part of foreign capital assistance for RFMs in LICs flows through these mechanisms. Operationally the technique is very simple. A central bank may offer to rediscount loans made for selected purposes at rates much lower than normal rediscount rates. This provides lenders with a wider spread between rates paid for loanable funds and rates which can be charged to the ultimate borrower. If the spreads are wide enough, this technique can be very powerful in inducing lenders to rediscount certain kinds of loans with central banks.

This technique has several serious weaknesses, however. The first is that rediscounting certain types of loans with central banks may not result in much additional lending in the desired direction. Because of fungibility, for example, a lender may rediscount most of its small farmer loans and use the additional loanable funds to expand lending to large borrowers.

The second and more serious weakness in this technique is that it may sharply reduce the incentives for lenders to mobilize part of their loanable funds through savings deposits. In all too many cases lenders get funds from central banks through rediscount mechanisms at lower rates than they must pay for voluntary household deposits.

Differential Interest Rates

Many countries apply interest rates to agricultural loans which are lower than regular commercial rates. As mentioned earlier, it is also common for policy makers to assign interest rate limits on small farmer loans, or loans for special development projects which are lower than regular agricultural loans. Other things being equal, these lower interest rates discourage lenders from servicing the very target group or sector stressed by the policy maker. Why should a lender be excited about lending to small farmers at 8 percent when they can lend to others at higher rates? Typically, the concessionary priced loan is aimed at a target group which has been difficult for lenders to service. Often, the lenders' costs of servicing this group are hgher than is true of other borrowers. The low interest rates, combined with higher costs, give lenders double disincentives to evade lending to the intended target group.

6. Policy Suggestions

Not all observers are convinced that RFMs are performing poorly. Researchers still have a good deal of work to do in carefully documenting and explaining the recent performance of RFMs. Further, cynics argue that RFMs are very effective in doing what policy makers really want done. They argue that covert objectives are to buy and maintain political support from powerful people in the society. It is for this reason that the benefits from current RFM policies flow to elites. As Lipton has pointed out, this may result from a convergence of interests on the part of beneficiaries and policy makers rather than from outright conspiracy (Lipton, p. 19). Cheap credit and lax loan recovery procedures are part of the system to buy "big votes" in the society. The ease of expanding loan portfolios and manipulating interest rates makes RFMs a very seductive political tool. If the cynics are correct, neo-classical economists have little useful to say about recent events in RFMs; Marxian tools of analysis are more appropriate.

It is too early for me to join the cynics camp, but after working on RFM issues in more than a dozen LICs, I am convinced that most RFMs are not helping these countries to realize publically stated objectives. The adverse effects of rapidly expanding RFM activities on income distribution, resource allocation and capital formation are too serious to be ignored or excused. It is also clear to me that this poor performance is the result of faulty policies based on incorrect assumptions.

I continue to hope that these faulty policies will be changed if policy makers are clearly shown the inconsistencies between current policies and overt public objectives.

Policy makers and researchers need to reassess the role which RFMs should play in the development process. I feel that major changes in how RFMs are used are long overdue. Some of these changes include the following:

a. Policies and programs which stress mobilization of voluntary financial savings in rural areas should be initiated. These policies should include strong incentives for households to save in financial forms, as well as providing convenient and inexpensive ways for households to hold their savings. Initially, savings mobilization and not credit allocation should be the top priority for RFMs.

b. Flexible, nominal interest rate policies should be adopted which allow RFMs to charge and pay positive real rates of interest on agricultural loans and savings deposits.

c. Interest rate policies plus other incentives should be used to induce a major portion of the financial market in a country to service rural financial needs.

d. Much less emphasis should be placed on allocating loanable funds among sectors, lenders, and borrowers by administrative fiats. Market forces and realistic prices in RFMs should be the main way of forcing lenders, borrowers, and savers to act in ways consistent with efficiency, equity, and development goals in market economies.

e. Much less attention should be focused on concessionary interest rates as a way of inducing small farmers to use formal credit. Instead, attention should focus on reducing borrowers' loan transaction costs. Concessionary interest rates have a strong adverse impact on the willingness of lenders to service agriculture in general and small farmers in particular. Higher rates would help to overcome this problem and would have little effect on loan demand among small and new borrowers.

f. If monopoly profits exist in informal RFMs, concessionary interest rates on formal credit, even with large credit supply increases, will not cure this problem. Higher interest rates on formal credit would induce formal lenders to compete away part or all of these monopoly profits.

Critics might argue that these policy suggestions ignore political realities, and that concessionary priced credit is needed to buy widespread political support in rural areas. It seems to me that this view overlooks a very important point; low interest rates on credit force governments and lenders to set even lower rates on financial deposits. In most societies, enlightened policies could result in a larger number of people holding savings deposits than the number receiving credit. As a result, in reasonably democratic societies, higher interest rates on savings deposits may elicit more widespread political support than is lost by higher rates on credit. Higher interest rates on credit may result in expanded opportunities for small farmers to get formal loans at lower total borrowing costs. If the above holds, the net political effect of flexible and generally higher interest rates on formal financial activities in rural areas may be to influence positively more, rather than less, votes for governments in power.

The changes in RFM policies suggested here will be no panacea for low income countries. Other commonly used development techniques such as technological change, improvements in water control, land reform, investments in infrastructure, and appropriate pricing policies must be front and center in most rural development programs. At best, RFMs play only a supporting role in these activities. I feel that too many of the current RFM policies and received wisdom on this topic are of "Dark Age" vintage, and that it is time to drag rural financial market policies into the 20th Century.

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FOOTNOTES

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1/ For a review of these problems see the various papers prepared for the A.I.D. Spring Review of Small Farmer Credit sponsored by the Agency for International Development. A summary of many of the points made in these papers can be found in Donald's book.

2/ The recent reversion to strict Islamic Laws on interest payments in several Islamic countries, and the blowing up of the Central Bank in Kampuchea suggests that a good deal of latent animosity still lingers about.

3/ These assumptions can be found scattered in most of the literature on agricultural finance in LICs published in the 1950s and 1960s. For example, see Belshaw and Bauer.

4/ These views are especially prominent in literature which treats Pakistan, India or Bangladesh.